TAX CONSEQUENCES OF NON-SHAREHOLDER CONTRIBUTIONS TO CORPORATE CAPITAL *

THE Internal Revenue Code of 1954 changes the tax treatment of non-shareholder contributions to corporate capital. Non-shareholder transfers of money or property to corporations ordinarily are designed to permit capital expansion or subsidize operating expense.[1] Although courts properly noting that donative intent is lacking in such subsidies have consistently refused to classify them as gifts,[2] they have also been unwilling to allow a tax on all subsidization. Accordingly, certain subsidies have been classified as contributions to capital and excluded from the corporation's taxable income. The doctrine excluding such contributions was developed by courts examining individual subsidies when the tax depreciability of the related assets was not questioned.[3] But exclusion and depreciation combined to offer a double tax benefit—receiving the asset tax-free, a corporation could later deduct depreciation from taxable income.[4] Recognizing the impropriety of the double benefit, courts narrowed the definition of capital contribution in order to curtail the possibilities of corporations deriving this advantage. In so doing, they departed from the precedent determining taxability on the basis of a contribution's intended use and introduced other tests for making this determination.[5] In the 1954 Code, section 118 adopts the former judicial exclusion of capital contributions,[6] but section 362 eliminates the prior practice allowing depreciation deductions.[7] Section

*Teleservice Co. of Wyoming Valley, 27 T.C. No. 84 (Jan. 29, 1957).

1. See notes 9-11 *infra* and accompanying text.

2. See Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943); Edwards v. Cuba R.R., 268 U.S. 628 (1925).

3. See notes 8-10 *infra* and accompanying text.

4. See MAGILL, TAXABLE INCOME 391-92 (rev. ed. 1945) (recommending inclusion in gross income and allowance of subsequent depreciation deductions); Freeman & Speiller, *Tax Consequences of Subsidies to Induce Business Location*, 9 TAX L. REV. 255, 263 (1954); Rottschaefer, *The Concept of Income in Federal Taxation*, 13 MINN. L. REV. 637, 668-69 (1929); Note, 98 U. PA. L. REV. 757, 760 (1950).

5. See notes 13-15 *infra* and accompanying text.

6. INT. REV. CODE OF 1954, § 118 reads:

> "[I]n the case of a corporation, gross income does not include any contribution to the capital of the taxpayer."

The term "contribution to capital" first appeared in the federal income tax statutes in Revenue Act of 1932, § 113(a)(8)(B), 47 STAT. 200, re-enacted without change in Int. Rev. Code of 1939, § 113(a)(8)(B), 53 STAT. 42, which provided a basis for property acquired as a contribution to capital. INT. REV. CODE OF 1954, § 118 was the first statutory exclusion of contributions to capital from gross income. The leading case of judicial exclusion is Edwards v. Cuba R.R., 268 U.S. 628 (1925).

7. INT. REV. CODE OF 1954, § 362(c) provides:

> "[I]f property other than money is acquired by a corporation . . . as a contribution to capital, and is not contributed by a shareholder as such, then the basis of such property shall be zero.
>
> "[I]f money is received by a corporation . . . as a contribution to capital, and is

362's elimination of this added benefit invites a re-examination of the definition of capital contributions.[8]

The function which a given subsidy was designed to perform originally determined its classification as a capital contribution or taxable income. Judicial exclusion of capital contributions from taxable income originated in *Edwards v. Cuba R.R.*[9] And the doctrine there announced, that government subsidizations of capital outlays were capital contributions, was followed in later decisions.[10] On the other hand, government contributions designed to subsidize operating expenses, or to maintain a guaranteed level of income were readily held taxable income to recipient corporations.[11] Since the former type of subsidy, through furnishing capital assets, gives the corporation capacity to earn income, while the latter compensates it for income not earned, this dichotomy rests on the functional nature of each subsidy. In developing this functional approach to taxability, however, the courts did not consider that holding a subsidy to be a capital contribution entailed the added benefit of subsequent depreciation deductions.[12]

Later courts, disturbed by the effect of depreciation deductions, departed from a functional approach and analyzed taxation of subsidies in terms of the contributors' motives. In *Detroit Edison Co. v. Commissioner*, the corporation had required prospective customers to subsidize the capital expansion necessary to provide them with electricity.[13] Finding that the contributors expected "direct" benefits, the Court viewed the subsidies as prepayments for services, which constituted taxable income rather than contributions to capital.[14] But in

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> not contributed by a shareholder as such, then the basis of any property acquired with such money . . . shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction . . . of the basis of any other property held by the taxpayer."

Shareholder contributions to capital continue to give rise to tax deductible depreciation. INT. REV. CODE OF 1954, § 362(a)(2).

When the contribution has consisted of money rather than property the courts have had no difficulty in relating assets subsequently acquired to the funds thus contributed. See, *e.g.*, Detroit Edison Co. v. Commissioner, 319 U.S. 98, 102 (1943).

8. Re-examination is forcibly suggested by SEN. REP. No. 1622, 83d Cong.,, 2d Sess. 18 (1954) which states that § 118 "in effect places in the code the court decisions on this subject."

9. 268 U.S. 628 (1925).

10. Southern Ry. v. Commissioner, 74 F.2d 887, 890 (4th Cir. 1935); Commissioner v. Norfolk So. R.R., 63 F.2d 304, 306 (4th Cir. 1933); Terminal R.R. Ass'n, 17 B.T.A. 1135, 1162 (1929). See S. E. Overton Co., 2 B.T.A. 1160 (1925); S. E. Overton & Co. v. Holden, 15 Am. Fed. Tax R. 521 (D. Mich. 1927).

11. Texas & Pac. Ry. v. United States, 286 U.S. 285 (1932); Boston Elevated Ry. v. Commissioner, 131 F.2d 161 (1st Cir. 1942); Kansas City So. Ry. v. Commissioner, 52 F.2d 372 (8th Cir. 1931).

12. No cases decided before Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), considered the interrelation of depreciation allowances and exclusion of capital contributions. See, *e.g.*, cases collected in notes 10, 11 *supra*.

13. 319 U.S. 98 (1943).

14. The initial judicial tendency was to adhere strictly to the *Cuba* doctrine. See, *e.g.*, Rio Electric Co., 9 B.T.A. 1332 (1928). In a series of decisions involving customer

Brown Shoe Co. v. Commissioner, a civic group subsidization of corporate relocation was held a capital contribution on the ground that the expected benefits would be general to the community and "indirect" to the contributors.[15]

Contributor motivation as the test of taxability was further emphasized in *Teleservice Co. of Wyoming Valley*—the latest pronouncement on capital contributions subject to a depreciation allowance.[16] The corporation agreed to furnish rural antenna service to prospective televiewers who subsidized construction of the system.[17] While holding the subsidies to be taxable income on the authority of *Detroit,* the court introduced a new method of viewing subsidization. Altruistically inspired subsidies were to qualify as tax-free capital contributions; those motivated by self-interest became prepayments for services and thus taxable income.[18]

But contributor motivation is an improper standard for judging capital contributions. Whether the contributors receive direct customer benefits by inducing the corporation to expand its plant and facilities or indirect community benefits through effecting corporate relocation, the subsidies are still designed to enlarge the corporation's capital, not to increase its income through reducing its operating expenses. Moreover, the benefit test of *Detroit* overlooks the economic reality that indirect community benefits are often much greater than those received by prospective customers.[19] And the contractual obligations

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contributions for the expansion of utility company services, the recipient companies were held not to have received income within the meaning of the Sixteenth Amendment. Tampa Electric Co., 12 B.T.A. 1002 (1928); Wisconsin Hydro-Electric Co., 10 B.T.A. 933 (1928); Rio Electric Co., *supra.* Although only the deductibility of depreciation was at issue in *Detroit,* the Court stated that "neither in form nor in substance" were Detroit Edison's customers contributing anything to the company. 319 U.S. at 102. And the decision has been interpreted as overruling the earlier line of cases. See Freeman & Speiller, *supra* note 4, at 258; O'Meara, *Contributions to Capital by Non-shareholders,* 3 TAX L. REV. 568, 571-72 (1948); Mandell, *Do Subsidies Constitute Taxable Income?,* 26 TAXES 323 (1948).

15. 339 U.S. 583 (1950).

Cases involving contributions to capital made by civic groups prior to the 1954 Code, once decided on the authority of *Cuba,* must now come under the narrower doctrine of *Brown* in order to avoid the *Detroit* holding. This suggests that when individuals within the civic group are to receive "direct" benefits, the capital contribution category may not be applicable. *But see* Freeman & Speiller, *supra* note 4, at 262, arguing that *Brown* overrules rather than distinguishes *Detroit.*

16. 27 T.C. No. 84 (Jan. 29, 1957).

17. Non-business televiewers applying for services after the system was partially completed were only required to make reduced contributions; and once the necessary capital outlays were completed, no contribution was demanded from such applicants. 27 T.C. No. 84, at 5. A contribution only made customers eligible to receive services; actual use of the system was then paid for at the regular monthly rates. *Ibid.* This was the arrangement in *Detroit,* Reply Brief for Petitioner, p. 8 n.1, Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), and is a general pattern in the customer contribution situation. See cases collected at note 20 *infra.*

18. 27 T.C. No. 84, at 9. A similar distinction has previously been made. See Baboquivari Cattle Co. v. Commissioner, 135 F.2d 114, 116 (9th Cir. 1943).

19. "The two big shoe companies, International Shoe and the Brown Shoe Company, both emphasized that in almost all cases their pay rolls have far exceeded the

imposed on corporations in exchange for subsidization demonstrate that all non-shareholding contributors expect substantial long-range benefits. In addition to making their product available to contributors,[20] for example, corporations have been required to remain in their new location for a given period [21] or to maintain a minimum payroll.[22] These restrictions also indicate that the *Teleservice* refinement of the benefit test is unrealistic.

Through adding the requirement of altruism, *Teleservice* exaggerates the impropriety of contributor motivation as a test of taxability. Altruism is a more stringent requirement than donative intent: although many donors are not altruistically motivated their donative intent is often unassailable.[23] Yet, to the extent that taxability of subsidizations has been determined by the contributor's intent, this standard has always been recognized as less strict than that regulating gifts.[24] Since recipients of capital contributions receive fewer tax benefits than donees under the 1954 Code, it seems reasonable to maintain less restrictive requirements for the former category.[25] Further, the *Teleservice* court indicated that it might consider only government sudsidies sufficiently altruistic to receive non-recognition treatment.[26] Not only is this posi-

guarantee[d minimum]. Each company justifies the subsidy by the importance of the indirect benefits to the commercial and professional people of the community."

McLaughlin & Robock, Why Industry Moves South 113-14 (1949). The importance of the "indirect" benefits expected may be gauged by the size of the contribution made. Freeman & Speiller, *supra* note 4, at 257 n.13, report that a Tennessee community offered a relocating paper plant a contribution of $20,000,000.

20. Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943); Reply Brief for Petitioner, p. 8 n.1, *ibid.*; Decatur Water Supply Co. v. Commissioner, 88 F.2d 341 (7th Cir. 1937); Rio Electric Co., 9 B.T.A. 1332 (1928).

21. Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950); Watervliet Paper Co., 16 B.T.A. 604 (1929); Frank Holton & Co., 10 B.T.A. 1317 (1928).

22. Commissioner v. McKay Products Corp., 178 F.2d 639 (3d Cir. 1949); C. L. Downey Co. v. Commissioner, 172 F.2d 810 (8th Cir. 1949); S. E. Overton & Co. v. Holden, 15 Am. Fed. Tax R. 521 (D. Mich. 1927).

23. See, *e.g.*, Speaker v. Keating, 36 F. Supp. 556 (E.D.N.Y.), *rev'd on other grounds*, 122 F.2d 706 (2d Cir. 1941) (primary motive for inter vivos gift to child was to prevent husband from inheriting statutory share).

24. Edwards v. Cuba R.R., 268 U.S. 628, 632 (1925) (although capital contributions not considered gifts because of contributor's self-interest, subsidy not disqualified as capital contribution). See Allen v. Smith, 173 U.S. 389, 402 (1899) ("bounties granted by a government are never pure donations"). See also Paul, Selected Studies in Federal Taxation 164 (2d ser. 1938).

25. Int. Rev. Code of 1954, § 102 excludes gifts from the donee's taxable income. Section 1015(a) provides, generally, that the donee acquires the donor's basis. In contrast, § 362, see note 7, *supra*, restricts the basis of property contributed by non-shareholders to zero.

26. "We think that the Supreme Court, in deciding the *Cuba Railroad* case, did not intend that the theory of that case should be extended so as to free from taxation a *private* contribution made in consideration of the performance of the contributee's normal business function." (Emphasis added.)

27 T.C. No. 84, at 9. Earlier, the court indicated that *Teleservice* is to be distinguished from *Cuba* because in the former case the contributors were non-governmental and selfish, while in the latter "governmental and altruistic." *Ibid.*

tion inconsistent with the *Brown* holding under the 1939 Code, it cannot be reconciled with present congressional reports and Treasury regulations which clearly extend the application of section 118 beyond the scope of government contributions.[27]

Moreover, with section 362 denying depreciation deduction for assets attributable to capital contributions, the *Detroit* and *Teleservice* tests are no longer purposeful. In *Detroit* the Court sought to confine the concept of capital contributions in order to preclude corporations from receiving tax-free subsidies and then recouping "through untaxed depreciation accruals on investment it . . . refused to make."[28] *Teleservice*, which followed *Detroit*, was presumably based on the same unwillingness to allow double tax benefits.[29] Of course, excluding subsidies from a corporation's taxable income works to its advantage regardless of depreciation allowance. Absent this exclusion, the entire contribution would be taxable in the year received.[30] Further, retention of the amount saved from taxation with its attendant earning power is clearly preferable to a long-term, problematical recoupment through depreciation deductions. While Congress has expressly countenanced this advantage, it has foreclosed double tax benefits by enacting section 362. And since 362 directly accomplishes the result sought by *Detroit* and *Teleservice*, their tests need not be retained.

In addition, the prepayment of services rationale in *Detroit* and *Teleservice* should be irrelevant to classification of the questioned subsidy under the 1954 Code. True, subsidization of a capital outlay is a form of prepayment in that the costs of acquiring new capital assets, which the corporation would normally pass on to its customers, are paid in advance. But the fact of prepayment does not require treating such subsidies as taxable income under the 1954 Code. On the contrary, the elimination of depreciation allowance suggests capital contribution treatment. For classifying subsidizations of capital outlay as capital contributions would equate their tax treatment with that given functionally equivalent methods of financing corporate capital expenditures. For example, customers wishing to subsidize corporate expansion could purchase $100,000 of corporate bonds with no tax consequences to the corporation.[31] Assuming the principal of the bonds to be due in twenty years and the interest payable at $5,000 a year, the corporation, amortizing its liability on the principal, would

27. S. REP. No. 1622, 83d Cong., 2d Sess. 18 (1954); U.S. Treas. Reg. § 1.118-1 (1957). See 7 MERTENS, FEDERAL INCOME TAXATION § 38.20 (Zimet ed. 1956); G.C.M. 16952, 1937-1 CUM. BULL. 133.

28. 319 U.S. 98, 103 (1943).

29. Although Teleservice Co. did not claim an immediate depreciation deduction, the court must have been unwilling to make the double benefit possible by entering a contrary holding. For the court expressly relied on *Detroit* which was directly concerned with precluding the double benefit. 27 T.C. No. 84, at 9; see text at note 28 *supra*.

30. 27 T.C. No. 84. *But see* text at notes 41, 42 *infra*.

31. See Union Land Co. v. Commissioner, 45 F.2d 944 (7th Cir. 1930); Southport Mill, Ltd. v. Commissioner, 38 F.2d 986 (5th Cir. 1930); Townsend-Ueberrhein Clothing Co. v. Crooks, 41 F.2d 66 (W.D. Mo. 1930).

charge these customers $10,000 a year more than if they had contributed the $100,000. Since this $10,000 additional taxable income to the corporation would be offset by a $5,000 a year interest payment deduction [32] and a $5,000 annual deduction for depreciation, computed straight-line for twenty years on the assets purchased with the $100,000,[33] the resulting tax consequences would be neutral over the twenty year period. And when the bonds became due the corporation would have recouped its $100,000 liability through the additional charges. If the financing were effected in a transaction which qualified under section 118, these additional charges would be unnecessary, and the corporation would have neither the depreciation nor the interest paid deductions. Thus the economic and tax consequences to the corporation would be identical under either transaction.

Concomitantly, contributors would experience equivalent results under either a capital contribution or bond transaction. In a capital contribution, contributors would relinquish the initial $100,000 plus the interest that could be earned on this amount. If, instead, the bond transaction were utilized to effect the subsidy, the customers would initially pay $100,000 and would receive $5,000 each year as bond interest. When this $5,000 is deducted from the $10,000 additional annual charge, the customers would in effect be paying $5,000 a year more for services than they would be in the case of a capital contribution. In the course of twenty years, this annual charge would amount to the $100,000 which they would recover as return of the bond principal.[34] With a total outlay of $300,000 and a total receipt of $200,000, the bond holding customers would experience the same loss of principal as if they originally had made a contribution to corporate capital. Moreover, assuming the prevailing interest rate to be 5%, the customers would lose the same amount of interest in each case. The interest on the bonds, amounting to $5,000 a year, can be set off against one-half of the additional charge. The other half of that charge causes the bond holding customers a $5,000 net annual expense. Thus their lost interest equals the simple interest on $100,000 for twenty years plus the compound interest on an annual increment of $5,000 for the same period. This is identical to the lost interest of the capital contributors—compound interest on $100,000 for twenty years. Non-business customers, however, would experience relative tax disadvantages in the case of a bond transaction; the $5,000 a year bond interest would be taxable income,[35] while the additional service charges would not be deductible.[36] But since this tax disadvantage would be divided among many customers, and since business customers could deduct the excess charges,[37] the tax consequences would generally be similar

32. INT. REV. CODE OF 1954, § 163(a).

33. *Id.* § 167(a)(1).

34. This recovery would not be taxable unless the retirement payment amounted to more than the original cost. *Id.* § 1232(a)(1).

35. *Id.* § 61(a)(4).

36. *Id.* § 262.

37. *Id.* § 162.

under either a section 118 or bond transaction. In any event, the identical economic consquences to the corporation militate in favor of achieving identical tax consquences by classifying subsidizations of capital outlay as capital contributions.

Admittedly, a similar tax result could be achieved by taxing the subsidy pro rata over the useful life of the related asset. The relevant analogy lies in the cases considering the taxability of prepayments for services to accrual taxpayers. Where such prepayments have been held taxable in the year received, the decisions rest on the recipient's complete control over the prepaid amount.[38] But customer contribution cases invariably involve imposition of elaborate restrictions on use of the subsidies.[39] Thus those cases in which accrual taxpayers had only restricted use of prepayments are applicable. And taxation of prepayments in such cases has been based upon an allocation of the prepaid amounts to the years in which the services were to be rendered.[40] Similarly, sudsidies would be allocated over the useful life of the related asset for purposes of taxation. And since deductions for depreciation of the subsidized assets would be allowed, the resulting tax consequences would remain neutral.[41]

38. South Dade Farms, Inc. v. Commissioner, 138 F.2d 818 (5th Cir. 1943); Your Health Club, Inc., 4 T.C. 385 (1944); South Tacoma Motor Co., 3 T.C. 411 (1944). See also Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944) (customer prepayments for processing tax held income in year received, though tax refunded to customers when taxing statute held unconstitutional).

39. See notes 20-22 *supra.*

As long as the recipient corporation is contractually bound to acquire capital assets with contributed funds, and is restricted in the use of such assets, it should not be required to segregate these funds on its books. *Cuba* did not require the capital contribution to be earmarked in the recipient's books in order to insure allocation of the contributed funds for the agreed upon capital purpose. See Fletcher, *Taxability of the Government Subsidy,* 12 GEO. WASH. L. REV. 245, 281-82 (1944). Nevertheless, in order to distinguish the *Cuba* situation more effectively from that involved in Texas & Pac. Ry. v. United States, 286 U.S. 285 (1932), see note 11 *supra* and accompanying text, some courts have insisted upon bookkeeping mechanics. See Lykes Bros. S.S. Co. v. Commissioner, 126 F.2d 725 (5th Cir. 1942); Baboquivari Cattle Co. v. Commissioner, 135 F.2d 114 (9th Cir. 1943).

40. Woodlawn Park Cemetery Co., 16 T.C. 1067 (1951); Veenstra & DeHaan Coal Co., 11 T.C. 964 (1948); Summit Coal Co., 18 B.T.A. 983 (1930).

41. Under existing law, subsidies held to be income are taxed in their full amount in the year received. See note 30 and accompanying text *supra.* But Congress has approved the accrual taxpayer's allocation of prepaid income to the years in which earned, irrespective of the quantum of control over the prepaid amount. INT. REV. CODE OF 1954, § 452 (repealed by 69 STAT. 134 (1955)). Repeal was forced upon Congress by administrative and revenue considerations having no bearing upon the principle of § 452; the congressional debates show a clear legislative intent to re-enact, at some future date, a similar provision without the loopholes unwittingly drafted into § 452. 101 CONG. REC. 3686, 7084 (1955).

While a § 452 solution may be feasible with respect to customer contributions of the *Detroit* and *Teleservice* variety, it would be difficult to apply to relocation subsidies. For relocated corporations benefit communities indefinitely, thus making a realistic allocation of these contributions extremely difficult. Since the capital contributions category has greater utility in relocation situations, and since an application of § 452 or of § 118 would yield identical results in the case of customer contributions, it seems preferable to treat qualified subsidizations as capital contributions.

However, classifying subsidizations of capital as capital contributions within section 118 is more consistent with the economic nature of such subsidies.[42] The characteristic restrictions on use, by limiting the corporation's interest in a subsidy to effecting the contractual purpose, preclude initial realization of economic gain. Such restrictions require the corporation to utilize the subsidy in the contemplated business activity. Since any other use would be a breach depriving the corporation of all interest in the subsidy, the realizable economic gain is necessarily produced by the business activity.[43] Instead of immediate gain, then, the corporation in fact receives a source of future income. Although such income is clearly taxable, the source—capital—from which it derives should be beyond the scope of income taxation.[44] Accordingly, subsidizations of capital outlay should be recognized as contributions to capital, excluded from taxable income by section 118, but giving rise to future income taxable under section 61.

42. For a summary of the economic arguments, see Freeman & Speiller, *supra* note 4, at 276-77.

43. See note 20 *supra* and accompanying text.

44. Edwards v. Cuba R.R., 268 U.S. 628, 633 (1925) (these subsidies not "income within the meaning of the Sixteenth Amendment"). The district court opinion, 298 Fed. 664 (S.D.N.Y. 1921), contains a full exposition of this principle. See United States v. Oregon-Washington R.R. & Nav. Co., 251 Fed. 211, 213 (2d Cir. 1918), where Judge Learned Hand observes that income

> "unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself, and it should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed."

See also Harvey, *Some Indicia of Capital Transfers Under the Federal Income Tax Laws*, 37 MICH. L. REV. 745 (1939). *But see* MAGILL, *op. cit. supra* note 4, at 386; Rottschaefer, *supra* note 4, at 669.